

## **Industry Comments On Proposed Uniform Regulation for Apportionment of Income for the Telecommunications and Other Industries**

### Introduction:

Through the proposed Regulation for Apportionment of Income for the Telecommunications Industry, the MTC has expressed a desire to eliminate the UDITPA Cost of Performance (COP) receipts sourcing provisions for the telecommunications industry, and mandate that a "service address", or other sales tax concept, be used as a replacement for COP. If MTC perceives that the use of COP for the apportionment of sales results in an inequity, the specific concerns should be addressed, rather than mandating a significant change from the current UDITPA provisions for just certain industries.

If the perceived problem is the "all or nothing" apportionment set forth in the current UDITPA COP rule, the rule should be modified rather than it being thrown out completely. Using a rule based on the variable ratio of direct costs incurred within a state to direct costs incurred everywhere eliminates this problem. In stead of assigning 100% of the revenue from sales of services to the state in which the greatest costs of performance are incurred and nothing to all other states, the proportionate approach would apportion a share of sales to all states in which the service is provided.

While sales tax concepts may work for some services, they do not work for all telecommunication services. For example, a service address, or other sales tax concept, may be appropriate for sourcing sales for the provision of local exchange service, but it has no relevance to directly connected data services. For these services, proportionate COP will more clearly reflects where the service is consumed, rather than service address or other sales tax concepts. Inherently, interstate service is another example where COP more accurately reflects where the service is consumed. The customer is purchasing the service provided across the entire route of the call, not just where the person originates or receives the call. Therefore, different methodologies are appropriate for different types of telecommunications service.

If MTC modifies or eliminates the COP apportionment methodology, the change should have universal application to all services rather than being limited to telecommunications and "similar" services. The lines between telecommunications, information services, and other types of communication services over similar platforms are being blurred. While the MTC draft attempts to bring some of these other services into the definition of telecommunications, the approach brings about other inequities. Wherever the rule attempts to draw a line, it will always create a new level of inequity. While MTC may feel that telecommunications and cable are similar – drawing the line at that point will create inequities between cable and other entertainment services. Consequently, requiring different treatments for similar sales can lead to needless complications, inequities and litigation. At a minimum, the proposal should clearly describe the services for which the rule applies., The regulation should not expand

accepted definitions (i.e. telecommunications) to include other industries for the sake of convenience.

The industry is very concerned about the administrative burden that the proposed changes produce. Since data and accounting systems have been developed to implement the COP methodology for certain revenue streams, to require the whole industry to change to a service address, or other sales tax concept, situsing rule for all services will place a substantial burden on portions of the industry. New data collection processes would need to be developed and implemented at substantial cost with no gain to the operations other than to comply with a new tax rule. Such new systems will be in addition to existing processes that must be retained for products sold by telecommunications companies that are not subject to this regulation.

The industry group is working to provide a detailed "red-line" review of the 5-26-2004 MTC draft regulation regarding the sourcing of telecommunications sales for income tax apportionment. Although this effort is not complete, we desire to share with the MTC our current thoughts. Therefore, our preliminary suggested changes and comment are contained below. After each suggestion, a "Comment" section explains the reasoning for the change. Since the suggestions contained in this response are not complete, we will continue to work with the MTC. As evidenced by discussions on the July 13, 2004 call, the MTC's current proposal is not complete, and further efforts are necessary by both groups. After the industry group has finalized its review of the draft regulation, we would appreciate meeting with the MTC so that both parties can exchange thoughts and ideas on the proposed regulation.

Response to Specific MTC Proposal

**Proposed Uniform Regulation for  
Apportionment of Income from the Sale of Telecommunications  
and Similar Services  
(5-26-04)**

Draft – For Discussion Purposes Only

**Special rules: Telecommunications and similar service providers.** The following special rules are established with respect to the apportionment of income from the sale of telecommunications and similar services by a person that earns income ~~is taxable~~ both in this state and in one or more other states.

Comment: It is only important whether the activity earns income in more than one state, regardless whether it is taxable or not. If a company has telecommunications or similar service income only in California and Nevada, the absence of taxability in Nevada should not remove the income from being subject to this regulation.

(1) In general. When a person providing telecommunication or similar services has income from sources both within and without this state, the amount of business income from sources within this state from such business activity shall be determined by Article IV of the Multistate Tax Compact and the regulations issued thereunder by this state, except as modified by this regulation.

(2) Definitions.

- (i) Ancillary services mean services that are associated with or incidental to the provision of telecommunications services, including but not limited to detailed telecommunications billing, directory assistance, vertical services, and voice mail services.

Comment: The term “ancillary services” has a specific definition within the Streamlined Sales Tax Project (SSTP) definitions, and these services should not be included within the separately defined term “telecommunications services.” A tentative agreement has been reached between industry and state representatives regarding these definitions. They will be voted upon at the August meeting. It is suggested that consistent definitions be utilized for transactional taxes and income taxes. This avoids duplicative development and maintenance of parallel data and accounting systems. Therefore, whatever definition is finally accepted by the SSTP should be utilized in this regulation for consistency and ease of administration.

(ii) "Information service" means:

Comment: The 5-26-2004 draft regulation includes "information services" within the definition of "telecommunications and similar services". This service should be considered separate from telecommunications, and definitions regarding this service should be provided by members of the Information service industry.

(iii) "Internet access service " means:

Comment: The 5-26-2004 draft regulation includes "Internet access service" within the definition of "telecommunications and similar services". This service should be considered separate from telecommunications, and definition regarding this service should be provided by members of the Internet access service industry.

(A) "Place of Primary Use" means the street address representative of where the customer's use of the telecommunications service primarily occurs, which must be the residential street address or the primary business street address of the customer. In the case of mobile telecommunications services, "place of primary use" must be within the licensed service area of the home service provider.

Comment: This term is used in the definition of "service address" and should be defined. We do not want to use the Mobile Telecommunications Sourcing Act (MTSA) definition for landline, and interexchange carriers because of the concept of the "licensed service area" used in the MTSA is not applicable for these carriers after the Telecommunications Act of 1986.

~~(i) "communication" means any sign, signal, writing, image, sound or intelligence of any nature including voice, data, text, audio, video, or any other information or instructions.~~

~~(ii) "telecommunications" means the electromagnetic transmission, conveyance, routing, emission or reception of communication by or through the use of any medium, including wires, cables, satellite, microwave, electromagnetic waves, light waves, radio waves, the internet, or any combination of those or other media now in existence or that might be devised. Telecommunications does not include the communication content of any such transmission, conveyance, routing, emission or reception.~~

Comment: By using the SSTP definition of telecommunications services, the need for these two definitions ("communications" and "telecommunications") is no longer necessary.

"telecommunications services" means the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a

point, or between or among points. The term "telecommunications services" includes such transmission services in which computer processing applications are used to act on the form, code or protocol of the content for purposes of transmission, conveyance or routing without regard to whether such services are referred to as enhanced or value added services.

The term does not include:

- a. The offering of a capability that allows data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser where the primary purpose of the underlying transaction is the data. It does not include the processing or manipulation of data where the primary purpose of the underlying transaction is to allow the transmission, conveyance or routing of the data.;
- b. Installation or maintenance of wiring or equipment on a customer's premises;
- c. Tangible personal property;
- d. Advertising, including but not limited to directory advertising.
- e. Billing and collection services provided to third parties;
- f. Internet access service;
- g. Radio and television audio and video programming services including any medium used to transmit these services ;
- h. Ancillary services; or
- i. Digital products delivered electronically, including but not limited to software, downloaded music or reading materials.

Comment: The above is utilized by the SSTP.

(iv) "telecommunications or similar service Listed Services" means the provision of any telecommunications, including telecommunications provided by resellers. The term includes, but is not limited to, , telephone service, facsimile service, telegraph service, paging service, personal communication services, satellite telephone service, mobile or cellular telephone service, and related fees and ancillary services, including universal service fees, detailed billing service, directory assistance, service initiation, service disconnection, voice mail service, and vertical services, such as caller ID and three-way calling. In addition, the term includes, but is not limited to, the provision of telecommunication network access, information service, voice over internet protocol services, cable or satellite television or radio programming distribution, Internet access service, web search portals, and data processing services. telecommunications services, ancillary services, information services, Internet access services, and telecommunication network services.

Comment: The new term "Listed Services" incorporates the multiple industries' income that are intended to be subject to this regulation. A concern exists that if the term "telecommunications" is used to include all of the services that are to be governed by this

regulation, confusion will be created and we will experience "definitional creep". Ancillary services, information services, and Internet access services are separate types of businesses and are not included within the term "telecommunications" for other tax purposes. Therefore, although "Listed Services" may not be precise, we request that a more generic term be used to describe the multiple industries that are intended to be subject to this regulation.

~~(iv) "outerjurisdictional property" means tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in a telecommunications or similar service business, but that are not physically located in any particular state.~~

Comment: The telecommunications industry does not agree with the concept that investment located outside of a taxing jurisdiction does not earn a return on capital, and therefore, should be ignored in the apportionment of income. Consequently, it is suggested that the operative provisions of (3)(iv) be struck from the regulation, thereby making this definition unnecessary.

(v) A. "service address" means:

~~A. the location of the customer's equipment which originates or receives the communication, regardless of the address to which the fee for telecommunication or similar service is billed or from which it is paid. The location of the telecommunications equipment to which a customer's call is charged and from which the call originates or terminates, regardless of where the call is billed or paid.~~

Comment: The above suggestion makes the definition consistent with the SSTP effort. The MTC definition does not provide a definitive location since it uses "or" between originates and terminates. Under this rule, the sales could be sourced at two either of two locations (i.e. the origination or termination point). The SSTP definition describes an equipment location from which the transmission originates or terminates, and is "charged" for the call.

B. If the location in (2)(v)A of this section is not reasonably determinable, "service address" means the origination point of the signal of the telecommunications or similar service first identified by either the seller's system or in information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.

C. If the locations in divisions (2)(v)A and B of this section are not known, "service address" means the location of the customer's place of primary use as defined in the Mobile Telecommunications Sourcing Conformity Act.

Comments: As stated in the comments regarding the definition of "place of primary use", the MTSA contains a requirement that the PPU be within the "license service area" of the provider. This requirement is not applicable to landline and long distance companies after the enactment of the Telecommunications Act of 1986.

(vi) "telecommunication network access service" means the provision by a local exchange telecommunication service provider of the use of its local exchange network by an interexchange telecommunication service provider to originate or terminate the interexchange telecommunication service provider's traffic carried to or from a distant exchange.

Comment: This definition may need to be visited at a later date when the sourcing rules have been addressed further.

### (3) Apportionment and Allocation

- (i) ~~(i) A person having income from the provision of providing telecommunications or similar services. Listed Services that is are earned taxable both within and without this state shall allocate and apportion such income, or any distinct portion of such income, derived from the provision of Listed Services its net income as provided in this rule.~~

Comment: As drafted, this provision gives the impression that any "company" having telecommunication income must allocate and apportion its total "net income" in accordance with this regulation.

Taxpayers should not be limited to a single method of apportionment. For example, if a company sells both local exchange access and long distance, systems have already been established for each type of telecommunications revenue. The local exchange service has historically utilized concepts similar to the service address, while the long distance portion of the revenue has been required to use cost of performance. Provided the revenue is a type of service that is distinct for accounting purposes, companies should be allowed to continue using these systems. If there is a specific problem with either of the systems, the problem should be addressed, rather than throwing out the whole methodology. Further, since the company may sell tangible personal property in addition to providing telecommunications services, multiple methods of apportionment are appropriate depending upon the type of income being earned.

- (ii) All income generated from activities other than the provision of Listed Services shall be apportioned pursuant to Article IV of the Multistate Compact and the regulations issued thereunder.

Comment: This subparagraph addresses the income earned by a telecommunications provider that is still business income, but not subject to this regulation.

(ii) All items of nonbusiness income shall be allocated pursuant to the provisions of [Section 4 of UDITPA or state equivalent].

(iii) All business income shall be apportioned to this state by multiplying that income by the apportionment percentage. The apportionment percentage is determined by adding the taxpayer's sales factor, property factor and payroll factor and dividing that sum by three. If one of the factors is missing, the remaining factors are added and that sum is divided by two. If two of the factors are missing, the remaining factor is the apportionment percentage. A property, payroll, or sales factor is missing if the taxpayer has no such property, payroll or sales, respectively, anywhere.

(ivii) ~~Except as otherwise provided in this, or another, special rule, t~~The property factor shall be determined in accordance with [Sections 9, 10, and 11 of UDITPA][or state equivalent], the payroll factor in accordance with [Sections 13 and 14 of UDITPA][or state equivalent], and the sales factor in accordance with [Sections 15, 16 and 17 of UDITPA][or state equivalent].

~~(4-v)~~ Property Factor.

~~(i). Outerjurisdictional property that is used by a taxpayer in providing a telecommunications or similar service shall be excluded from the numerator and from the denominator of the property factor.~~

Comment: The whole concept of "outerjurisdictional property" should be stricken. Companies have invested capital in these areas and expect a rate of return on such investments. To reallocate the income earned on this investment is not consistent with business practices or economic theory. It is proper to include the "outerjurisdictional property" in the denominator, since it is invested capital and contributes to the ability of the company to earn income. It should not be included in a taxing jurisdiction's numerator if it is not physically located within that jurisdiction. Further, the telecommunication industry should not be singled out for this treatment. If the rule is retained, it should be applicable to all industries.

(5vi) Sales Factor Sales Factor Numerator. The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to, the following:

Comment: The industry feels that this regulation should minimize its disruption to companies using methodologies that have previously been mandated or approved by the MTC. Data and accounting systems have been developed in accordance with these methods at substantial cost. To



require companies that are currently in compliance with the MTC rules to rebuild these systems is an unreasonable request.

Therefore, since multiple methodologies are currently being utilized, the problems with each method should be separately addressed.

After the specific issues for each method are identified, members of the telecommunications industry will look forward to working with the MTC and the other industries affected by this regulation. Since there is not a clear understanding of these specific problems, no comments are made at this time regarding the propriety of the remaining portions of the proposed regulation.

A. receipts from charges for providing telecommunications or similar services access . "Telecommunication or similar service access in this state" means the ability to originate or terminate the electromagnetic transmission of a communication from a location within this state. An example of this type of receipt is a monthly subscriber fee or customer charge for the ability to originate or terminate a communication at a service address located in this state and without regard to the actual amount of communications originated or terminated at that service address.

B. receipts from charges for telecommunications or similar services not billed on a per-communication or other variable unit basis, if the service address is in this state. An example of this type of receipt is a fixed charge for unlimited telecommunication or similar service, or for up to a set amount or minutes of telecommunication or similar service.

C. receipts from charges for cellular or mobile telecommunications services required to be sourced under the Mobile Telecommunications Sourcing Act, Public Law 106-252, as it may be amended from time to time, if the source, as determined under that act, is in this state; [move – below "F"]

D. receipts from charges for telecommunications or similar services billed on a per-communication or other variable unit basis, if the communication originates and terminates in this state;

E. receipts from charges for telecommunications or similar services billed on a per-communication or other variable unit basis, if the communication either originates or terminates in this state, and the service address is located in this state;

F. receipts from any other charges for telecommunications or similar service if the service address is in this state.

G. receipts from charges for telecommunication network access if the purchasing interexchange carrier's network traffic originates and terminates in this state; or originates or terminates in this state, and the interexchange carrier's customer's service address is located in this state.

## Summary

The points presented in this preliminary response by the Telecommunications industry are as follows:

1. If there are problems with the COP methodology, these issues should be specifically addressed, rather than throwing out the whole concept.
2. If the MTC modifies or eliminates the COP apportionment methodology, the change should have universal application to all services rather than being limited to telecommunications and "similar" services
3. Portions of the telecommunications industry have developed data and accounting systems that comply with the current MTC sourcing rules. These companies should be allowed to continue using such methods, rather than having to incur substantial costs to comply with new regulations that are potentially additive to existing system used for other services.
4. The definitions used by the MTC for sourcing should be consistent with those adopted by the SSTP effort.
5. The proposed regulation has included multiple industries within the term "telecommunications". Each industry should be separately identified, rather than being swept into the definition of telecommunications. These industries should be given an opportunity to participate in the process.
6. The telecommunications industry does not agree with the modification to the property factor that excludes "outerjurisdictional" property. Companies have invested capital in these areas and expect a rate of return on such investments. To reallocate the income earned on this investment is not consistent with business practices or economic theory.
7. The specific sourcing rules are being considered by the MTC and with input by the industry. Further discussions are anticipated as the parties work through this area. .